DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 03-0166
Adjusted Gross Income Tax
For the Year 1998

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ISSUES

I. Business / Non-business Classification – Adjusted Gross Income Tax.

Authority: IC § 6-3-2-2; *Wabash, Inc. v. Dep't of State Revenue*, 729 N.E.2d 620 (Ind. Tax Ct. 2000); *Twentieth Century-Fox Film Corp. v. Dept. of Revenue*, 700 P.2d 1035 (Or. 1985).

Taxpayer protests the reclassification of income derived from an I.R.C. § 338(h)(10) election from business income to nonbusiness income.

STATEMENT OF FACTS

Sub W was a corporation based in Indiana. For several years prior to 1998, Sub W and a number of other corporations were wholly owned by a parent corporation which filed federal consolidated income tax returns; however, Sub W filed separate Indiana income tax returns.

In 1996, Sub W's parent corporation was acquired by another corporation ("Acquirer"). Because Acquirer was not based in the United States, Sub W and other acquired corporations could not file consolidated income tax returns. However, Taxpayer and two other subsidiaries were eligible to file consolidated returns in Indiana. On November 30, 1997, Taxpayer and other domestic companies owned by Acquirer were contributed to a new company ("New Company"). New Company was eligible to file a consolidated federal income tax return, of which Taxpayer was the reporting company.

On December 26, 1997, Sub W was sold to an unrelated corporation as part of an agreement entered into on November 17, 1997. As a result of the purchase, New Company made an election under I.R.C. § 338(h)(10) to treat the sale of Sub W's stock as a deemed sale of Sub W's assets for the fair market value of the stock. The effect of this election was to cause Sub W to realize income on the deemed sale of its assets and include that income on New Company's consolidated federal income tax return, while Sub W received a stepped-up basis in its assets.

For the first and only time as part of Taxpayer's consolidated group, Taxpayer filed a consolidated return including Sub W and treating the gains from the I.R.C. § 338(h)(10) election

as business income. Sub W was not included on a consolidated return or a unitary return prior to Taxpayer's return for the year at issue. However, the Indiana Department of State Revenue ("Department") determined that the sale of assets was in fact non-business income allocable to Sub W's commercial domicile, Indiana, and assessed additional tax against Taxpayer.

Previously, the Department issued a letter of findings partially sustaining and partially denying Taxpayer's protest. Taxpayer requested a rehearing, which the Department granted. A hearing was held, and this supplemental letter of findings results.

I. Business / Non-business Classification – Adjusted Gross Income Tax

DISCUSSION

The issue before the Department is the availability of the "stacked" method that the Department proposed using in the Department's prior letter of findings.

Under IC § 6-3-2-2(*l*), the Department may take various remedial measures to fairly represent Taxpayer's and Sub W's income from Indiana sources for Taxpayer's and Sub W's business activity. In addition to three methods listed in subsection (*l*), the Department may also employ "any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC § 6-3-2-2(*l)*(4).

While the general rule for consolidated returns is that the "standard method" (i.e., the members of the consolidated group are considered as one business for tax purposes), as prescribed in *Wabash, Inc. v. Dep't of State Revenue*, 729 N.E.2d 620 (Ind. Tax Ct. 2000), the "stacked" method (i.e., each company Indiana income for Indiana purposes is determined separately, then added together to reach the consolidated group's overall Indiana income) is an available remedial provision under IC § 6-3-2-2 (*l*). The standard method is the preferred method for filing a consolidated return, while the stacked method is a method that can be applied, albeit in relatively rare circumstances. If an alternative filing method such as the stacked method is not permissible as a remedial measure, then the language of IC § 6-3-2-2(*l*)—expressly permitting remedial measures for situations in which regular apportionment and allocation methods do not fairly reflect a taxpayer's income—is rendered meaningless for consolidated corporate income tax returns.

Even though the stacked method is a method for consolidated filing that can be used only in rare circumstances, Taxpayer's situation is one of those circumstances due to the normal method's significant underreporting of Taxpayer's Indiana income. Sub W historically had an Indiana apportionment factor of approximately 90 percent. Sub W sought to offset its income with business deductions for salaries, equipment, and other necessary expenses for its entire history until November 30, 1997. However, Sub W's sale, agreed to prior to its membership in the consolidated group, resulted in a $120,000,000 gain—derived largely from Indiana sources—transforming into a $9,000,000 gain (basically, computing the income and apportionment factors with Sub W in the consolidated group, and then without Sub W in the consolidated group). In effect, Sub W has sought to benefit from deducting 90 percent of its expenses for Indiana tax

purposes for years, but the resulting income generated by the sale of its assets—the converse of its deductions—is only reported at about eight percent of Sub W's total income.

In addition, the employment of a stacked method would reflect the fact that Sub W had always been a separate filer for several years, even when it was eligible to file federal consolidated returns, and had no tax relationship with the other members of the consolidated group other than 26 days in which Sub W's sale to a third party was a foregone conclusion.

Furthermore, Taxpayer's position regarding consolidated filing of corporate tax returns—namely, that once corporations such as those affiliated with Taxpayer elect to file consolidated tax returns, that the standard method of consolidated filing must be used absent extraordinary circumstances specifically mentioned in the *Wabash* case—results in the potential for absurd results. For instance, if a highly profitable company with relatively small property, payroll, and receipts operates in a handful of states, while a relatively less profitable company with substantially larger property, payroll, and receipts operates in several states, a taxpayer can dilute the income from the highly profitable company by including the apportionment factors with the lower relative income of the larger, less profitable company in states where both companies conduct business. The less profitable company may have a greater portion of its income apportioned to the states where both companies conduct business; however, that increased income is more than offset by the reduction in apportionment factors for the income of the highly profitable company.

In the states where only the less profitable company conducts business, the more profitable company's income is excluded, resulting in a substantial portion of the more profitable company's income becoming subject to tax nowhere. The result of sheltering considerable income from taxation in all jurisdictions runs afoul of a basic objective of corporation tax statutes such as Indiana's—the apportionment and allocation of no more and no less than one hundred percent of a corporation's income *somewhere*. *See generally Twentieth Century-Fox Film Corp. v. Dept. of Revenue*, 700 P.2d 1035, 1038, 1043 (Or. 1985). Under the circumstances discussed, a stacked method can result in closer to one hundred percent of the respective companies' incomes becoming subject to tax in at least one jurisdiction, by apportioning each company's income on a separate company basis, which would result in one hundred percent of each company's income being apportioned to the states where the respective company conducted business, and by not permitting the companies to cross-dilute the companies' respective income. This cross-dilution may have occurred between Taxpayer and Sub W, though the Department cannot state that with

However, Taxpayer's argument that a "pure" stacked method (i.e., all companies are determined separately, rather than one entity carved out, the carved-out entity's income is determined separately, then the other companies use a standard method) is applicable in this instance is correct. Accordingly, Taxpayer's income should be determined based on a pure stacked method.

Taxpayer raised various other contentions during the hearing. Though the Department understands the nature of Taxpayer's other concerns, the other concerns do not result in a change in the Department's previous letter of findings except as previously noted.

FINDING

Taxpayer's protest is sustained with respect to the issue of whether the gain from Sub W's sales is business income, and to the extent that a pure stacked method should be used for Taxpayer's separate entities. Taxpayer's protest with respect to Taxpayer's application of the standard method of apportionment is denied.

JR/BK/DK-September 18, 2006